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Supreme Court of the United States

October Term, 1979
No. 79-1149

ALLSTATE SAVINGS AND LOAN ASSOCIATION, Successor-in-Interest to Metropolitan Savings and Loan Association of Los Angeles,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petitioner's Reply to Memorandum for Respondent in Opposition to Petition for Writ of Certiorari.

ROBERT J. WYNNE,
HILL, WYNNE, TROOP & MEISINGER,
1801 Century Park East, 5th Floor,
Los Angeles, Calif. 90067,
(213) 553-6901,
Counsel for Petitioner Allstate Savings and Loan Association.

Parker & Son, Inc., Law Printers, Los Angeles. Phone 724-6622

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By its Memorandum ("Mem.") in opposition to the Petition for Writ of Certiorari herein ("Pet."), the Government itself has confirmed both the need for this court's review of the decision below and, more importantly, the necessity for its reversal.

Nowhere in its opposition does the Government attempt to analyze, much less deny, the reasons advanced by Petitioner for granting the Writ. Indeed, the Solicitor General expressly acknowledges that this is a case of first impression which involves an extremely important and novel question of Federal Income Tax Law which affects the entire savings and loan industry. (Mem. at 3).[1]

[1]The Government's statement that the issues herein involve banks (Mem. at 1) is incorrect. IRC §595 does not apply to banks.

Moreover, and more importantly, even in its brevity, the Solicitor General's demonstrably erroneous arguments support the Ninth Circuit's decision starkly expose the fallacy of the Government's position in this case and, concomitantly, the blatant errors below.

The Government does not dispute that the post-foreclosure expenses in issues would *not* have been chargeable to Metropolitan's bad debt reserves prior to the enactment of IRC §595. Nor does the Government dispute that the Secretary's Regulations having the force and effect of law[2] expressly and unambiguously state that IRC §595 *does not* change the tax treatment of post-foreclosure expenses. (Mem. at 5).

Rather, by an amazing bit of "Carrollesque logic" the Government argues that the clear and unambiguous language of Treas. Reg. §1.595-1(e)(7), which plainly states that IRC §595 does not change the tax treatment of *any* post-foreclosure expense except post-foreclosure depreciation (App. E at 38), is inapplicable to post-foreclosure selling expenses because such expenses are not specifically mentioned in the *examples* (which, of course, do not purport to be, and obviously are not, exclusive) set forth in Treas. Reg §1.595-1(e)(8) which illustrate the operation of Treas. Reg. §§1.595-1 (e)((6) and (7). According to the Government's specious "analysis," the fact that post-foreclosure selling expenses not mentioned in these examples somehow "shows" that Treas. Reg. §1.595-(e)(7) applies to ". . . only those expenses incurred during the interim

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[2]Treas. Reg. §1.595-1(e)(7) (Appendix ("App.") E to Pet. at 38).

period between the foreclosure and the subsequent sale of the property." (Mem. at 5).[3]

Clearly, had the Secretary intended IRC §595 to change the tax treatment of the post-foreclosure expenses in issue he would have expressly said so as he did in the case of post-foreclosure depreciation. The fact that the Secretary excluded only post-foreclosure depreciation from the operation of the all-encompassing statement in Treas. Reg. §1.595-1(e)(7) (which is logical since foreclosed property takes on the non-depreciable, *non-capital asset* characteristics of the underlying indebtedness involved) makes it obvious that Treas. Reg. §1.595-1(e)(7) was specifically intended to apply to *all* post-foreclosure expenses except post-foreclosure depreciation *which is expressly* excluded therefrom. Any doubt in this regard, and there seriously can be none here, must be resolved against the Government and in favor of Petitioner. *Gould v. Gould*, 245 U.S. 151, 153 (1917); *United States v. Merriam*, 263 U.S. 179, 187-88 (1923); *Allstate Insurance Company v. USA*, 530 F.2d 378, 384-85 (Ct. Cls. 1976).

Manifestly, the Government's question-begging conclusion that Treas. Reg. §1.595-1(e)(7) only applies to "interim" post-foreclosure expenses, and thus does not apply to the post-foreclosure selling expenses in issue, is not only completely illogical but more importantly totally nonsensical.

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[3]This argument is irreconcilably inconsistent with, and indeed is repudiated by, the 1972 Technical Advice (App. G at 46) wherein the Internal Revenue Service expressly held that post-foreclosure repairs, insurance and real estate taxes, none of which are specifically referred to in the examples under Treas. Reg. §1.595-1(e)(8), are *not* chargeable to a savings and loan association's bad debt reserves but rather are separately deductible under IRC §162(a) in the absence of accountability therefor under applicable local law.

Why should post-foreclosure selling expenses be treated any differently than any other type of post-foreclosure expense for *bad debt purposes* when, as the Solicitor General expressly recognizes (Mem. at 2), *all* such post-foreclosure expenses are incurred for the same reason—to facilitate the sale of foreclosed property as soon as practicable after the acquisition thereof so as to enable Metropolitan to maximize recovery of, and collect, the underlying indebtedness secured thereby?

Incredibly, the Solicitor General suggests that the distinction between the tax treatment of post-foreclosure selling expenses and other post-foreclosure expenses somehow lies in the income-producing nature of the underlying security property involved:

> "The examples thus properly recognize that where the savings institution takes over the operation of income-producing property, it is engaging in a business activity separate and apart from an original loan transaction, and that the expenses and income realized in this regard should be reported accordingly, rather than under the special rules of Section 595." (Mem. at 5-6).

However, this attempted "distinction" is expressly contradicted by the Internal Revenue Service itself in the 1972 Technical Advice (App. G) in which the Commissioner specifically rejected any notion that the concept of accountability is restricted only to post-foreclosure maintenance expenses incurred with respect to income-producing property. In ruling that all of the post-foreclosure expenses there is issue, including minor repairs, routine maintenance, insurance and taxes, were not required to be taken into consideration under IRC §595 for bad debt purposes, but rather

were deductible under IRC §162(a), the Commissioner himself expressly concluded that whether or not the foreclosed property involved was income producing was totally irrelevant to its conclusion that, in the absence of accountability for such expenses under applicable local law, all such post-foreclosure expenses were deductible. (App. G).

The reason, of course, why the concept of "accountability" applies with equal force to *all* types of post-foreclosure expenses, whether incurred with respect to income or non-income producing foreclosed property, relates to the obvious rationale for the Secretary's employment, in his binding, legislative regulations,[4] of the concept of accountability to differentiate between post-foreclosure expenses which should be taken into consideration for *bad debt purposes* under IRC §595 (through charges to the bad debt reserve) and those which should not: if there is accountability for an item of post-foreclosure expenses—*i.e.*, it becomes part of the underlying debt and the borrower is liable therefor—then plainly such post-foreclosure expenses (whatever their nature) should be taken into consideration for *bad debt purposes* by charges to the bad debt reserve under IRC §595. Conversely, and just as clearly, if there is no accountability for an item of post-foreclosure expense—*i.e.*, it does not become part of the underlying debt and the borrower is not liable therefor—then such post-foreclosure expenses (whatever their nature) should not be taken into consideration for *bad debt purposes* by charges to the bad debt reserve under IRC §595 but rather must be separately deductible under IRC §162(a). After all, IRC §595 is only concerned with the *bad debt consequences* of mortgage

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[4]Treas. Reg. §1.595-1(e)(8) (App. G at 40).

foreclosure and thus should not apply to post-foreclosure expenses if the amount of the underlying *debt* is not affected thereby.

The Commissioner himself has so ruled on two separate occasions (Apps. F and G). According to the Commissioner's own technical advices, IRC §595 and the Secretary's Regulations provide that the only way an item of post-foreclosure expense can be charged to the bad debt reserve under IRC §595 is through a basis adjustment to the foreclosed property involved and the only time such basis adjustment is required is when there is accountability for the post-foreclosure expense involved under applicable local law. (App. F. at 44-45 and App. C at 48-49). The Commissioner logically concludes therefore that, where, as here, the debtor is not accountable to the lender for *any* post-foreclosure expenses under applicable local law, *all* such post-foreclosure expenses—both those incurred in connection with the maintenance of foreclosed property pending the sale thereof as well as those incurred in connection with the disposition thereof—are *not* includable as adjustments to the basis to such properties and therefore are *not* required to be taken into consideration for *bad debt purposes* under IRC §595 but rather should be, and are, deductible under IRC §162.

These rulings are not only "persuasive" evidence of the true meaning of IRC §595 (*Hanover Bank v. CIR*, 369 U.S. 672, 686 (1962)), but indeed provide the inexorably compelling logic which mandates the conclusion that "accountability" is and should be the dispositive factor in this case: whether post-foreclosure expenses are required to be taken into consideration ("capitalized") for *bad debt purposes* through charges

to the bad debt reserve under IRC §595 depends solely upon whether such post-foreclosure expenses are required to be includable as basis adjustments to the foreclosed properties in respect of which incurred; and, whether post-foreclosure expenses are required to be includable as basis adjustments to the foreclosed properties in respect of which incurred depends *solely* upon whether there is accountability therefor under applicable local law.

In the last analysis, it is absolutely ridiculous to conclude, as the Solicitor General has done here, that post-foreclosure costs of maintaining income-producing foreclosed property pending the ultimate disposition thereof are deductible under IRC §162(a) if, under applicable local law, there is no accountability therefor, but that identical post-foreclosure costs of maintaining non-income producing property are not deductible irrespective of accountability therefor under applicable local law. Similarly, it makes absolutely no sense to conclude that, irrespective of the type of foreclosed property involved, post-foreclosure costs of maintaining foreclosed property in saleable condition pending an ultimate sale thereof are deductible but that post-foreclosure costs incurred in selling the same foreclosed property are not deductible. Yet, these types of irreconcilable and absurd results are not only sanctioned by the decisions below but are now specifically endorsed by the Solicitor General. (Mem. at 5-6).

The ineluctable fact is that there is no substantive distinction for *bad debt purposes* between expenses incurred in this case by Metropolitan to maintain foreclosed property pending a sale thereof and expenses incurred by Metropolitan to sell such property. Both types of expenses are incurred for the identical pur-

pose—to facilitate the disposition of foreclosed property as soon as possible after foreclosure—and all such expenses must be treated alike for federal income tax purposes: deductible or nondeductible depending solely upon whether there is accountability therefore under applicable local law. The Secretary's Regulations under IRC §595 having the force and effect of law, as well as the Commissioner's very own rulings, could not make this point more clearly.

The confusion concerning the scope of IRC §595's "preemptive" effect on the deductibility of post-foreclosure expenses by savings and loan associations (Pet. at 19) is thus clearly manifested, and the need for this court's review and reversal of the decisions below is thus irrefutably demonstrated, by the Government's very own memorandum.

Respectfully submitted,

ROBERT J. WYNNE,
of HILL, WYNNE, TROOP & MEISINGER,
Counsel for Petitioner Allstate Savings and Loan Association.